

[JOINT COMMITTEE PRINT]

**DESCRIPTION OF S. 1113  
RELATING TO  
THE USE OF TAX-EXEMPT INTEREST IN  
DETERMINING THE AMOUNT OF  
TAXABLE SOCIAL SECURITY BENEFITS**

**SCHEDULED FOR A HEARING**

**BEFORE THE**

**SUBCOMMITTEE ON SOCIAL SECURITY  
AND INCOME MAINTENANCE PROGRAMS**

**OF THE**

**COMMITTEE ON FINANCE**

**ON**

**August 1, 1983**

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**PREPARED BY THE STAFF**

**OF THE**

**JOINT COMMITTEE ON TAXATION**



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(III)

## INTRODUCTION

The Subcommittee on Social Security and Income Maintenance Programs of the Senate Committee on Finance has scheduled a public hearing on August 1, 1983, on S. 1113, (sponsored by Senators D'Amato, Long, and others), providing that interest on obligations exempt from income tax would not be taken into account in determining the amount of social security benefits to be taxed.

The first part of this pamphlet is a summary of present law and the bill. The second part contains a description of present law, the issues raised by the bill, an explanation of the bill, estimated revenue effect of the bill, and examples of the effect of the bill on the amount of social security benefits included in gross income.

## I. SUMMARY

Under the Social Security Amendments of 1983, beginning generally in 1984, a portion of social security and tier 1 railroad retirement benefits is included in the taxable income of recipients whose incomes, including 50 percent of benefits, exceed a base amount. The base amount is \$32,000 for a married couple filing a joint return and \$25,000 for an individual. The portion of benefits subject to tax equals the lesser of (1) one-half of the benefits, or (2) one-half of the excess of (a) the taxpayer's adjusted gross income increased by interest exempt from income tax plus one-half of the benefits, over (b) the base amount. Thus, interest exempt from income tax is taken into account in determining the amount of a recipient's benefits subject to tax. Interest exempt from income tax includes interest on obligations which are issued by or on behalf of a State or local government and which satisfy various other restrictions, including restrictions on the character of the facilities or services to be financed with the bond proceeds.

The bill would modify the provision dealing with taxation of benefits in the Social Security Amendments of 1983 so that interest exempt from income tax would not be taken into account in determining the amount of a recipient's social security and tier 1 railroad retirement benefits subject to tax.

The provisions of the bill would take effect as if included in the Social Security Amendments of 1983.

## II. DESCRIPTION OF S. 1113

### A. Present Law

#### *Taxation of Social Security and Railroad Retirement Benefits*

Prior to the Social Security Amendments of 1983 (the "Act"), social security benefits were not included in the gross income of recipients for Federal income tax purposes. Under the Act, a portion of social security benefits is included in the gross income of recipients whose adjusted gross incomes exceed certain levels, beginning generally in 1984.

Social security benefits included in the gross income of a taxpayer for a taxable year are equal to the lesser of (1) one-half of the social security benefits received, or (2) one-half of the excess of (a) the taxpayer's adjusted gross income (determined without regard to the deduction for two-earner couples and various exclusions of foreign earned income), increased by interest exempt from income tax plus one-half of the social security benefits received, over (b) the appropriate base amount. Thus, interest on obligations exempt from income tax is taken into account in determining the amount of an individual's social security benefits that is taxed.

The base amount is \$32,000 in the case of a married individual filing a joint return; zero in the case of a married individual filing a separate return, unless he or she lived apart from his or her spouse for the entire taxable year; and \$25,000 in the case of all other individuals.

A social security benefit is defined as any amount received by the taxpayer by reason of entitlement to either (1) a monthly benefit under title II of the Social Security Act (Federal Old-Age, Survivors, and Disability Insurance Benefits (OADSI)), or (2) a Tier 1 benefit under the Railroad Retirement Act of 1974. The Act also provides that social security benefits potentially subject to tax include any workmen's compensation the receipt of which caused a reduction in social security disability benefits.

For the purpose of determining the amount of social security benefits received during a taxable year, a taxpayer is permitted to reduce benefits received during the taxable year by the amount of benefits, previously received during the current or any preceding taxable year, that he repays during the taxable year. An elective, special rule also is provided for taxpayers who received lump-sum payments partially or fully attributable to prior years. If this special rule is elected, the taxpayer includes in gross income for the year in which the payment is received only the sum of the increases in gross income that would result from taking into account the appropriate portions of the lump-sum payment in the years to which they are attributable.

The proceeds from the taxation of benefits, as estimated by the Secretary of the Treasury, are transferred each quarter to the trust funds from which benefits are paid. An annual report from the Secretary concerning the transfers is required.

In general, the foregoing provisions apply to benefits received after December 31, 1983, in taxable years ending after that date. However, the provisions do not apply to any portion of a lump-sum payment received after December 31, 1983, if the generally applicable payment date of this portion is before January 1, 1984.

### *Obligations Exempt From Income Tax*

#### *Income tax treatment*

Interest on State and local government obligations and on qualified scholarship funding bonds generally is exempt from Federal income tax (Code sec. 103).<sup>1</sup> However, obligations issued after June 30, 1983, must be in registered form in order for interest on the bonds to be exempt from tax. Additionally, exemption of interest on bonds whose proceeds are used for certain purposes is denied if certain Federally prescribed conditions are not met. Such bonds include industrial development bonds (IDBs), mortgage subsidy bonds, and arbitrage bonds.<sup>2</sup> Further, this exemption does not apply to capital gain realized on the sale or exchange of a bond.

#### *Industrial development bonds (IDBs)*

IDBs generally are bonds the proceeds of which are used in a trade or business other than a trade or business of a tax-exempt organization or governmental unit. Interest on IDBs is taxable unless the bonds are "exempt purpose" IDBs or "small issue" IDBs. Exempt-purpose IDBs are bonds issued to finance the following facilities: (1) projects for low-income residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities, or parking facilities; (5) sewage and solid waste disposal facilities, or facilities for the local furnishing of electricity or gas; (6) air or water pollution control facilities; (7) certain facilities for the furnishing of water; (8) qualified hydroelectric generating facilities; (9) qualified mass commuting vehicles; and (10) local district heating or cooling facilities. In addition, IDBs used to acquire or develop land as the site for an industrial park are exempt-purpose IDBs.

The proceeds of exempt small-issue IDBs may be used to finance any land or depreciable property, other than golf courses, country clubs, and other specified types or facilities, used in the trade or business of a taxable person. However, the aggregate face amount of the issue of which the bonds are a part may not exceed \$1 million. The \$1 million limitation is increased to \$10 million where the aggregate amount of capital expenditures made by the user satis-

<sup>1</sup> Bonds issued by volunteer fire departments are treated as State and local government obligations if certain conditions are satisfied.

<sup>2</sup> Interest on arbitrage bonds is taxable. These bonds are obligations issued as part of an issue, all or a major portion of the proceeds of which are reasonably expected to be used (directly or indirectly) to acquire certain securities, the yield on which is reasonably anticipated to be materially higher than that of the bonds in the issue.

fies certain limitations. The small issue exception expires with respect to bonds issued after December 31, 1986.

#### *Mortgage subsidy bonds*

An exemption from Federal income tax is provided for bonds issued to provide mortgage loans to certain purchasers of single-family residences (sec. 103A). Qualified mortgage bonds must satisfy various volume and targeting requirements and special arbitrage rules. The tax exemption for qualified mortgage bonds expires with respect to bonds issued after December 31, 1983.

Present law also exempts interest on qualified veterans' mortgage bonds. Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to finance mortgage loans to veterans. Unlike qualified mortgage bonds, the tax-exemption for veterans' bonds does not expire after December 31, 1983, and these bonds are not subject to the volume, arbitrage, and most of the targeting rules applicable to qualified mortgage bonds.

#### *Qualified scholarship funding bonds*

Qualified scholarship funding bonds are obligations issued by not-for-profit corporations organized by, or requested to act by, a State or a political subdivision of a State (or of a possession of the United States), solely to acquire student loan notes incurred under the Higher Education Act of 1965. The entire income of these corporations (after payment of expenses and provision for debt service requirements) must accrue to the State or political subdivision, or be required to be used to purchase additional student loan notes.

#### *Gift and estate tax treatment*

A Federal gift tax is imposed on certain gratuitous lifetime transfers and an estate tax is imposed on certain transfers occurring by reason of death. The value of State and local government bonds is subject to the Federal gift and estate taxes.

### **B. Issues**

One issue is whether an inequitable result would occur if certain taxpayers with substantial amounts of tax exempt interest were income to exclude all of social security benefits from tax while taxpayers with equal amounts of income from taxable bonds or other sources pay tax on some portion of benefits. The result is affected by the requirement under present law that interest exempt from income tax be taken into account in determining the amount of social security benefits to be taxed.

A second issue is whether the requirement is appropriate for, and effective in, preventing social security benefit recipients from reducing or avoiding taxation of benefits by investing in obligations yielding interest exempt from income tax, rather than taxable interest.

A third issue is whether the requirement under present law that interest exempt from income tax be taken into account in determining the amount of social security benefits to be taxed, constitutes taxation of tax-exempt interest, and, if so, whether the requirement violates the Constitution.

### C. Description of the Bill

The bill would amend the provision in the Social Security Amendments of 1983 which provides for the taxation of social security benefits so that interest exempt from income tax would not be taken into account in determining the portion of social security benefits subject to income tax. Thus, the portion of social security benefits subject to tax would equal the lesser of (1) one-half of the benefits received, or (2) one-half of the excess of (a) the taxpayer's adjusted gross income (determined without regard to the deduction for two-earner couples and various exclusions of foreign earned income) plus one-half of benefits, over (b) the appropriate base amount.

**Effective date.**—The provision would take effect as if included in the Social Security Amendments of 1983.

### D. Revenue Effect

The bill is estimated to reduce fiscal year receipts by \$8 million in 1984, \$31 million in 1985, \$47 million in 1986, \$63 million in 1987, and \$83 million in 1988.

### E. Examples of Calculation of Taxable Social Security Benefits

The effect of the bill may be illustrated with the following example. Under present law a taxpayer with \$30,000 of tax-exempt interest and \$8,000 of benefits would pay tax on half of benefits, i.e., \$4,000; an equivalent result obtains for a taxpayer with \$30,000 of taxable interest. Under the bill the first taxpayer would not include any benefits in adjusted gross income (AGI), while the second would continue to include \$4,000. The remainder of this section explains the formula used to determine the portion of benefits included in AGI and includes more detailed examples of the effects of the bill on the amount of benefits to tax.

#### *Examples Under Present Law*

The table following presents six examples which illustrate how the taxable portion of benefits depends on the amount of income (other than benefits) received by the taxpayer. For all six examples, it is assumed that the taxpayer is an unmarried individual who receives \$8,000 in benefits annually.

In example A, the sum of one-half of benefits (\$4,000) plus other income (other adjusted gross income (\$21,000) plus tax-exempt interest (none)) just equals the base amount (\$25,000). Since the sum does not exceed the base amount, no benefits are included in adjusted gross income (AGI). Thus, for all taxpayers receiving \$8,000 in benefits, \$21,000 is the lowest amount of other income which may be received without paying tax on some portion of benefits. In general, all taxpayers for whom other income is greater than the base amount minus one-half of benefits must include some portion of benefits in AGI under present law.

In example B, other AGI is the same as in example A, but the taxpayer has \$1,000 of tax-exempt interest. Half of benefits plus other income (\$26,000) now exceeds the base amount by \$1,000, and

half of this excess (\$500) is the amount of benefits included in AGI under present law.

Examples C and D are similar to A and B except that the taxpayers have \$25,000 (rather than \$21,000) of other AGI. The larger amount of other income leads to the inclusion of a larger amount of benefits in AGI. Example C illustrates the general rule that any taxpayer whose other income equals the base amount includes one-fourth of benefits in AGI.

In Example E, the sum of other AGI (\$29,000), tax-exempt interest (none), and half of benefits (\$4,000) equals \$33,000, which exceeds the base amount by \$8,000. Half of this amount, \$4,000, is included in AGI. Since \$4,000 also is half of benefits, however, this is the maximum amount of benefits included in AGI. This point is illustrated in example F, in which the taxpayer has \$1,000 of tax-exempt interest in addition to other AGI of \$29,000. Because half of benefits already is included in AGI, the additional income in the form of tax-exempt interest does not increase the amount of benefits subject to tax. In general, half of benefits is included in AGI for all taxpayers whose other income equals or exceeds the base amount plus half of benefits.

# Examples of Amounts of Social Security Benefits Taxed

[Unmarried taxpayers receiving \$8,000 per year of benefits]

| Example                                                                              |         |         |         |         |         |         |
|--------------------------------------------------------------------------------------|---------|---------|---------|---------|---------|---------|
|                                                                                      | A       | B       | C       | D       | E       | F       |
| 1. One-half of benefits.....                                                         | \$4,000 | \$4,000 | \$4,000 | \$4,000 | \$4,000 | \$4,000 |
| 2. Tax-exempt interest.....                                                          | 0       | 1,000   | 0       | 1,000   | 0       | 1,000   |
| 3. Other adjusted gross income (AGI).....                                            | 21,000  | 21,000  | 25,000  | 25,000  | 29,000  | 29,000  |
| 4. Sum of lines 1, 2, and 3.....                                                     | 25,000  | 26,000  | 29,000  | 30,000  | 33,000  | 34,000  |
| 5. Base amount.....                                                                  | 25,000  | 25,000  | 25,000  | 25,000  | 25,000  | 25,000  |
| 6. Line 4 minus line 5.....                                                          | 0       | 1,000   | 4,000   | 5,000   | 8,000   | 9,000   |
| 7. Amount included in AGI (lower of line 1 or one-half of line 6) under present law. | 0       | 500     | 2,000   | 2,500   | 4,000   | 4,000   |
| 8. Amount included in AGI under S. 1113.....                                         | 0       | 0       | 2,000   | 2,000   | 4,000   | 4,000   |

### *Examples Under the Bill*

Under the bill, taxpayers A and C would be unaffected, since they have no tax-exempt interest. Taxpayers B and D would have a tax reduction, since tax-exempt interest would not be used in determining the amount of benefits subject to tax. Thus, B and D would have the same amount of taxable benefits as A and C, respectively. However, taxpayer A and other hypothetical taxpayers whose other income is \$21,000 or less would not be affected because their other income is low enough so that no benefits are taxable whether or not tax-exempt interest is taken into account. Also, taxpayer F would not be affected, since his other AGI is high enough so that half of benefits is included in AGI even without taking account of tax-exempt interest.

In general, therefore, the bill would reduce includible benefits for taxpayers who have some includible benefits under present law, who have tax-exempt interest, and whose other AGI is lower than the base amount plus half of benefits; these are the taxpayers for whom some, but less than half, of benefits would be taxed if tax-exempt interest were not used in the calculation. On the other hand, the bill would not affect taxable benefits for two groups of taxpayers—those whose other AGI plus tax-exempt interest is sufficiently low that taxable benefits are zero under present law and those whose other AGI is sufficiently high so that half of benefits would be taxed even if tax-exempt interest were not used in the calculation.

It should be noted, however, that these statements do not take into account any portfolio shifts and, thus, shifts in the amounts of other AGI and tax-exempt interest, which could occur if the bill were in effect. Depending on taxpayers' marginal tax rates, differences in yield between taxable and tax-exempt bonds, anticipated patterns of income in future years, and other factors, some taxpayers could change their holdings of tax-exempt bonds in response to the bill. Any such change would modify the analysis of the bill's effect on such taxpayers.